I. INTRODUCTION

The Banking Act of 1933, the Bank Holding Company Act of 1956 (BHC Act), and the Federal Reserve Act (FR Act) comprise the statutory framework that governs the extent of affiliation of banks and other business organizations and regulates the relationship between banks and such organizations under common ownership or control.

Section 18(j) of the Federal Deposit Insurance Act (FDI Act) extends the provisions of Sections 23A and 23B of the FR Act to state non-member banks. Section 23A (which was substantially revised by the Banking Affiliates Act of 1982) regulates transactions between a bank and its "affiliates" as that term is specifically defined in Section 23A. Section 23B of the FR Act was enacted as part of the Competitive Equality Banking Act of 1987 to expand the range of restrictions on transactions with affiliates. Section 10(b) of the FDI Act gives FDIC examiners the authority, in the course of examining insured banks, "...to make such examinations of the affairs of all affiliates of such banks as shall be necessary to disclose fully the relations between such banks and their affiliates and the effect of such relations upon such banks..." Section 10(d) of the FDI Act defines affiliate as having the same meaning as in Section 23A of the FR Act and as in Section 2(b) of the Banking Act of 1933.

This section of the Manual discusses affiliates and subsidiaries, including the restrictions on transactions between affiliates and insured banks, exceptions to those restrictions, and the examination authority of the FDIC with respect to affiliates of nonmember insured banks. It also familiarizes the examiner with the basic elements constituting a bank holding company as well as the effects a holding company relationship can have on subsidiary banks. Sections 23A and 23B of the FR Act and the BHC Act, as amended, are contained in the Prentice-Hall volumes.

II. BANK HOLDING COMPANIES

The elements constituting a bank holding company are set forth in Section 2 of the BHC Act. A "bank holding company" is defined to include any corporation, partnership, business trust, association, or similar organizations, or any long-term trust (one which extends beyond 25 years or 21 years and 10 months after the death of individuals living on the effective date of the trust) which has control over any bank or over any bank holding company. A bank, of course, is a company and, therefore, may be a bank holding company if it controls another bank or bank holding company. By virtue of amendments to the BHC Act, one-bank holding companies, partnerships, and under certain circumstances, bank trust departments are within BHC Act limits.

Definition of Control

Conclusive Presumption means the matter is not permitted to be overcome by any proof that the matter is otherwise. Under the BHC Act, a company has control over a bank or any other company (1) if it directly or indirectly owns or controls 25% or more of the voting shares or (2) if it controls, in any manner, the election of a majority of the directors of such bank or other company. Shares owned or controlled by any subsidiary of a bank holding company are considered to be indirectly owned or controlled by the holding company. Shares held or controlled directly or indirectly by trustees for the benefit of a company or the shareholders or employees of a company are deemed to be controlled by the company. The Federal Reserve Board (FRB) has by regulation determined that all of the situations described in this paragraph, which are based upon provisions of the BHC Act, constitute conclusive presumptions of control. According to FRB Regulation 225.2(a), whenever the transferability of 25% or more of any class of voting securities of a company is conditioned in any manner on the transfer of 25% or more of the voting securities of another company, the holders of the securities affected by the condition are a company for the purposes of the BHC Act, unless one of the issuers of the securities is a subsidiary of the other and is identified as such in a FRB order or in a registration statement or report accepted by the FRB under the BHC Act. For example: John Doe owns 15% of the shares of voting securities of Bank A and 15% of the shares of voting securities in Trust Company B. Richard Roe owns 10% of the shares of voting securities in Bank A and 10% of the shares of voting securities in Trust Company B. Both Doe and Roe hold their shares of voting securities in Bank A under an agreement which prohibits the transfer of any of such shares without the transfer of

shares of voting securities in Trust Company B. This agreement applies to all the shares of Bank A and Trust Company B held by Doe and Roe, which in the case of both companies amounts to 25% of their outstanding voting securities. Under the FRB regulations, Doe and Roe are a bank holding company.

Under another provision of the BHC Act, a bank or company is deemed to own or control voting shares of a bank acquired after December 31, 1970, and held in a fiduciary capacity, when such bank or company has sole discretionary authority to exercise voting rights with respect to such shares. Thus, a bank through its trust department would be considered a bank holding company when, as trustee bank, it holds 25% or more of the voting shares of another bank and has sole discretionary power to vote those shares, however, if the shares were acquired prior to December 31, 1970, the bank, through its trust department, would not be deemed a bank holding company unless the bank has both sole discretionary voting authority over those shares and the right to rid itself of those voting rights without having done so.

Rebuttable Presumption generally means that an inference holds good until it is invalidated by proof or a stronger presumption. Thus, if a bank or company falls within any of the following rebuttable presumption criteria, it would inferentially be deemed to be in control unless such bank or company could prove otherwise.

The FRB is authorized to determine whether a company has control over a bank or bank holding company if the FRB finds that such company directly or indirectly exercises a controlling influence over the management or policies of the bank or bank holding company. Also, a bank holding company (transferor) is deemed to indirectly own or control shares which after January 1, 1966, are transferred to any transferee that is indebted to the transferor, or has one or more officers, directors, trustees, or beneficiaries in common with or subject to control by the transferor unless and until the FRB determines that the transferor is not capable of controlling the transferee. In order to establish guidelines implementing these sections of the BHC Act, the FRB has adopted the following presumptions of control which may be rebutted by the affected company:

1. A company that owns, controls, or has power to vote more than 5% of the voting securities of a bank or bank holding company if; one or more of the company's directors, trustees or partners, or officers or employees with policy-making functions, serves in any of these capacities with the bank or holding company, and no other person owns, controls or has power to vote as much as 5% of any class of voting securities of the bank or bank holding company.

2. A company that owns, controls or has power to vote more than 5% of any class of voting securities of a bank or bank holding company if; additional voting securities are owned, controlled or held with power to vote by individuals or members of their immediate families (spouse, children, grandchildren, parents or their ancestors, stepchildren or stepparents, all whether natural or adopted) who are directors, officers, trustees or partners of the company (or own directly or indirectly 25% or more of any class of voting securities of the company) and such holdings together with the company's holdings aggregate 25% or more of any class of voting securities of the bank or bank holding company. The presumption does not apply under (1) and (2) where securities are held in a fiduciary capacity and the company does not have sole discretionary authority to exercise the voting rights.

3. A company that enters into any agreement or understanding with a bank or bank holding company (other than an investment advisory agreement), such as a management contract, pursuant to which the company or any of its subsidiaries exercises significant influence with respect to the general management or overall operations of the bank or bank holding company presumably controls such bank or bank holding company.

4. A company that enters into an agreement or understanding under which the rights of a holder of voting securities of a bank or other company are restricted in any manner, presumably controls the shares involved unless the agreement; is a mutual agreement among shareholders granting each other a

right of first refusal with respect to their shares, is incident to a bona fide loan transaction, or relates to restrictions on transferability and continues only for such time as may reasonably be necessary to obtain from a Federal bank supervisory authority with respect to acquisition by the company of such securities.

5. A company that directly or indirectly owns securities that are convertible immediately at the option of the holder or owner into voting securities, presumably owns or controls the voting securities.

In addition to the foregoing, the FRB may, under its regulations, administratively determine that a company controls a bank or other company. Congress has apparently established 5% as the benchmark for determining whether or not "control" exists and the FRB has to a great extent incorporated that benchmark into its regulations dealing with the rebuttable presumption of control. Accordingly, under the BHC Act, there is a presumption that a company does not have control over a bank or other company if the company directly or indirectly owns, controls, or has the power to vote less than 5% of the voting securities of such bank or other company. Furthermore, a company does not have control of a bank or other company unless at the time in question that company directly or indirectly owned, controlled, or had power to vote 5% or more of the voting securities of a bank or other company, or had already been found to have control by the FRB after notice and opportunity for hearing.

Control Not Covered by the BHC Act

Sections 2(a)(5)(A) through (F) list certain banks and/or companies which are not considered bank holding companies even though they may have "control" of another bank or bank holding company. No company is a bank holding company because of shares acquired in securing or collecting debt, provided it disposes of the shares within two years. No company is a bank holding company by reason of its ownership or control of shares acquired pursuant to an underwriting arrangement, provided the shares are held only long enough to permit their sale on a reasonable basis. A company formed for the sole purpose of participating in a proxy solicitation is not a bank holding company because it controls shares pursuant to proxy solicitation. No bank or company is a bank holding company by virtue of its ownership or control of bank shares in a fiduciary capacity when it does not have sole discretionary voting power with respect to such shares and when the shares are not held, owned, or controlled as provided in paragraphs (2) and (3) of Section 2(g) of the Act. (Refer to the Prentice-Hall volumes for further detail.) The remaining two exemptions (Sections 2(a)(5)(E) and (F)) are of limited application.

Acquisition of Bank Shares

Every organization coming within the definition of a "bank holding company" must register with the Board of Governors of the Federal Reserve System and the Board's prior approval must be obtained for the formation of any new bank holding company. All bank holding companies must obtain the Board's prior approval for the acquisition of ownership or control of more than 5% of the voting shares of any bank, or for the acquisition of substantially all of the assets of a bank, or for the merger or consolidation with any other bank holding company. (Sections 3(a)(1) through (5) of the Act.)

Section 3 of the Act also sets forth certain exceptions to the general prohibition against taking actions described above without the prior approval of the Board. No approval of the Board, prior or otherwise, is required for shares acquired by a bank in a fiduciary capacity; if the shares are in what might be termed a "short-term trust" (one that terminates within 25 years or not later than 21 years and 10 months after the death of individuals living on the effective date of the trust), if the bank does not have sole discretionary authority to vote the shares, and if the shares are not held, owned or controlled as provided in paragraphs (2) and (3) of Section 2(g) of the Act. Furthermore, although FRB approval is required under the Act where a trustee bank or company, after December 31, 1970, acquires bank shares with sole discretionary voting rights (in a short-term trust), such approval may be obtained subsequent to the acquisition of such bank shares. Application for approval must be filed within 90 days from the date of acquisition. If retention is disapproved, the acquiring bank has two years to dispose of the shares or of its sole discretionary voting rights in

the shares. No Board approval is needed for shares acquired by a bank as security for or in collection of a debt previously contracted in good faith, provided any shares acquired in this manner after December 31, 1970, are disposed of within two years from date of acquisition. Finally, a bank holding company may acquire additional shares in a bank in which the holding company owned or controlled a majority of the voting shares prior to such acquisition without obtaining any approval whatsoever.

Nonbank Activities of Bank Holding Companies

The BHC Act prohibits bank holding companies from; owning any voting shares of any company that is not a bank, engaging in any activities other than banking or managing and controlling banks, or furnishing services to or performing services for their subsidiaries, except as specifically authorized by the Act itself, or by the FRB under authority of the Act. Section 4 of the Act initially contains a flat prohibition against any bank holding company acquiring direct or indirect ownership or control of any voting shares in nonbanking organizations, but the remaining provisions of Section 4 set forth certain permissible activities of bank holding companies as well as certain exemptions from the flat prohibition.

Section 4(a)(2) of the Act provides that no bank holding company shall, after two years from the date on which it becomes a bank holding company, retain direct or indirect ownership or control of any voting shares in a nonbanking organization or engage in any nonbanking activity other than; managing or controlling banks and other authorized bank holding company subsidiaries, furnishing services to or performing services for its subsidiaries, and other activities closely related to banking as set forth in Section 4(c)(8). Section 4(a)(2) also provides a "grandfather" clause for those older companies which were made subject to the Act by the 1970 amendments and which controlled only one bank on June 30, 1968. Such a company was permitted to continue to engage in any activities, nonbank or otherwise, that it was engaged in as of June 30, 1968, unless the FRB in its discretion determined that such activity was contrary to the public interest and ordered the activity terminated (in such event, the company has ten years from the date of the FRB order to terminate). A bank holding company coming under the "grandfather" provision cannot directly or indirectly expand its nonbank "grandfathered" activities through the acquisition of any interest in or the assets of any going concern other than one which was its subsidiary on June 30, 1968. Generally, those companies, which by reason of the 1970 amendments to the Act became bank holding companies, had until December 31, 1980, to terminate all nonbank activities unless such activity came within one or more of the exemptions or permissible activities discussed below.

Exemptions - Section 4(c) of the Act absolutely exempts two classes of bank holding companies from the restrictions against the retention or acquisition of any interest in nonbank organizations. These companies may, therefore, retain their nonbank affiliates and may expand further in nonbanking fields without the approval of the FRB. One class consists of any bank holding company which is a labor, agricultural or horticultural organization and which is exempt from taxation under the Internal Revenue Code of 1954. The other class relates to any bank holding company in which more than 85% of the voting stock has been owned continuously since at least June 30, 1968, by or for members of the same family or their spouses. The FRB is also empowered to grant exemptions from the blanket restriction against nonbank activities by a bank holding company under Section 4(d), the so-called "hardship" clause.

Permissible Activities - In addition to exempting the classes of bank holding companies described in the paragraph immediately above, Section 4(c) of the BHC Act also sets forth certain permissible activities in which bank holding companies may engage, including the following:

1. Banking holding companies may own shares in any company engaged solely in one or more of the following activities: holding or operating properties used wholly or substantially by any subsidiary of the holding company; conducting a safe deposit business; furnishing or performing services to or for the holding company or its banking subsidiaries; or liquidating assets acquired from any other source prior to the date on

which such company became a bank holding company;

2. A bank holding company may indirectly hold shares of any company, if the shares were acquired by a bank in satisfaction of a debt previously contracted, or directly hold shares of any company, if the shares were acquired by the holding company because one of its subsidiaries was ordered by a supervisory authority to divest itself of the shares. In both cases, the shares so acquired must be sold within two years, although in the case of shares acquired in satisfaction of debts previously contracted, the FRB may extend the period of divestiture an additional three years;

3. A subsidiary bank may hold or acquire shares in a fiduciary capacity irrespective of the flat prohibition against engaging in nonbank activities provided the trust is short-term, as previously defined, and provided the shares are not held, owned or controlled as provided in paragraphs (2) and (3) of Section 2(g) of the Act;

4. Bank holding companies may hold shares of the kind and amount expressly eligible for investment by national banks under the National Banking Act (Section 5136 of the Revised Statutes);

5. Bank holding companies may hold shares of any company provided the shares do not exceed 5% of the outstanding voting shares of that company and,

6. Bank holding companies may hold shares of any investment company provided the investment company is not a bank holding company and is not engaged in any business other than investing in securities, none of which exceed 5% of the outstanding voting shares of any company.

Bank holding companies are also authorized to acquire shares of any company the activities of which have been determined by the Board of Governors, after notice and opportunity for hearing, to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In making these determinations, the FRB is required to consider whether the performance of a particular activity by an affiliate of a holding company can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. As of March 29, 1982, the following types of nonbank activities have been authorized by the FRB:

1. Making or acquiring mortgage, finance, credit card, or factoring loans;

2. Operating an industrial or Morris Plan bank;

3. Servicing loans;

4. Performing trust functions;

5. Acting as investment or financial adviser;

6. Leasing personal property and equipment or acting as agent, broker, or acting in baring such property;

7. Making equity or debt investments in corporations or projects designed primarily to promote community welfare;

8. (a) Providing bookkeeping or data processing services for the internal operations of the holding company and its subsidiaries and (b) storing and processing other banking, financial, or related economic data, such as performing payroll or billing services;

9. Acting as insurance agent or broker within certain limitations;

10 Acting as underwriter for credit life insurance and accident and health insurance within certain limitations;

11. Providing courier services;

12. Providing management consulting services to nonaffiliated bank and nonbank depository institutions within certain limitations;

13. Selling at retail of money orders having a face value less than $1,000 and selling of U.S. Savings Bonds and the issuance and sale of travelers' checks; and

14. Performing appraisals of real estate.

Grandfathered Nonbank Banks

Prior to the enactment of the Competitive Equality Banking Act of 1987 ("CEBA"), banks were defined for purposes of the Bank Holding Company Act ("BHCA") as institutions that accepted demand deposits and made commercial loans. If an institution accepted demand deposits but did not make commercial loans or vice versa, it was not a bank and any company that controlled such an institution was not a bank holding company for purposes of the BHCA. State or national banks that either accepted demand deposits or made commercial loans but not both became known collectively as "nonbank banks." These banks in many instances are owned by corporations otherwise engaged in a wide diversity of activities that otherwise make them ineligible to be bank holding companies.

The CEBA redefined the term "bank" for purposes of the BHCA to include any bank insured by the FDIC, thus eliminating any further creation of nonbank banks. In so doing, however, the CEBA also grandfathered a class of nonbank banks that would be permitted to operate outside the scope of the BHCA provided they observed certain limitations designed primarily to prevent unfair competition with banks controlled by bank holding companies.

The first limitation imposed by the CEBA prohibits a nonbank bank from engaging in any activity in which it was not lawfully engaged on March 5, 1987. This would prevent, for example, a nonbank bank from offering demand deposits or commercial loans if it were not offering those services on March 5, 1987.

Secondly, a nonbank bank may not offer or market any products or services of an affiliate that are not permissible for bank holding companies under the BHCA nor permit its product or services to be offered or marketed with those of an affiliate unless the particular products or services of the affiliate are permissible for bank holding companies under the BHCA, or unless the specific cross- marketing activity was conducted on March 5, 1987. In that event, the cross-marketing activity could continue but only in the same manner as conducted on March 5, 1987.

Thirdly, a nonbank bank may not permit an overdraft (including an intraday overdraft) by an affiliate on its books, or incur an overdraft in its account at a Federal Reserve Bank on behalf of an affiliate.

Lastly, a nonbank bank may not increase its assets at an annual rate of more than 7 percent during any 12 month period beginning after August 10, 1988, one year after the date of enactment of the CEBA. Compliance with this limitation is monitored directly by the Federal Reserve Board through the call reports.

The Federal Reserve Board alone is charged with enforcing these limitations and for this purpose may examine, require reports from and issue a cease-and- desist order against any grandfathered nonbank bank, including a state nonmember bank supervised by the FDIC.

Whenever a grandfathered nonbank bank within the FDIC's supervisory jurisdiction is examined and evidence of a possible violation of an applicable limitation is noted, the matter should be listed on the Violations page and also summarized in a memorandum to the file and submitted to the Regional Office for review and possible referral to the appropriate Federal Reserve Bank for consideration and any necessary follow-up action. In all cases, the comments section of the Affiliates and Holding Company page of the Report of Examination should note that the bank is a grandfathered nonbank bank.

For more specific information regarding the various limitations, see the relevant provisions of the BHCA, 12 U.S.C. 1843(f)(3) and Regulation Y, 12 C.F.R. 225.51, 225.52 and 225.145. These are included under the Bank Holding Company tab in the Prentice-Hall volumes.

Holding Company Affiliation Effect on Subsidiary Banks

A sound, well-managed holding company can be a source of strength for unit banks; however, if the condition of the holding company or its nonbank subsidiaries is unsound, the operation of subsidiary banks can be adversely affected.

Management - A primary benefit of affiliation with a holding company is the availability of management expertise. The bank holding company structure can add greatly to bank management by providing experts where specialized knowledge is essential. Management training programs within the holding company also provide the basis for successor management at the unit bank level. On the other hand, in the event a holding company management training program is adequate, the move from senior management in a unit bank into the holding company could leave a void at the bank level. If senior management tries to divide time between holding company and bank affairs, the individual may be spread too thin and performance could suffer at both levels.

Financial Considerations - The holding company structure can provide its subsidiary bank strong financial support because of greater ability to attract and shift funds from excess capital areas to capital deficient areas. The financial support can take the form of equity capital injections and/or the funding of loans and investments. However, when the financial condition of the holding company or its nonbanking subsidiaries is tenuous, pressures can be exerted on the subsidiary banks. In order to service its debt or provide support to another nonbank subsidiary, the holding company may place inordinate financial pressure on its subsidiary banks by any of the following methods: payment of excessive dividends; pressure subsidiary banks to invest in high risk assets to increase asset yields; purchase and/or trade its high quality assets for the other affiliate's lower quality assets; purchase of unnecessary services from affiliates; or payment of excessive management or other fees.

Although no formal policy statement has been issued by the FDIC, it has long been the FDIC's position that management and other fees paid by subsidiary banks should have a direct relationship to the value of actual goods or services rendered based on reasonable costs consistent with current market values for such services. Bank files should contain adequate information to permit a determination as to what goods and services are being provided and on what basis they are being priced. Charges should not be based on resources, deposits, or earnings of the bank. In those instances when payments are large and are not or could not be justified on the basis of services received by the bank, a comment on the Examiner's Comments and Conclusions schedule would be appropriate.

An additional method of upstreaming funds from a bank to its parent is through the remittance of income taxes to the parent which then files a consolidated income tax return. Due to timing differences arising from the use of different accounting methods for Reports of Income and Reports of Condition and for income tax purposes, a portion of taxes reflected in Reports of Income and Condition will be deferred; however, in certain instances, banks are required to remit to the holding company the entire amount of income tax expense, both current and deferred. The FDIC's Statement of Policy Income Tax Remittance by Banks to Holding Company Affiliates, indicates past transfers of this kind shall be restated on the bank's books and future tax transfers shall only include the current portion of income tax expense.

Even when the holding company is financially sound, difficulties may be encountered as the parent markets long-term debt to fund equity capital in the subsidiaries. Although this procedure, known as "double leveraging", does increase equity capital in the subsidiary, problems can occur. Since the holding company generally services the debt with dividends from the subsidiary, should the subsidiary encounter earnings reversals, it may not be able to pass dividends to the parent which must then create other means of generating cash.

Miscellaneous Considerations - The holding company structure can provide significant benefits from economies of scale in areas such as audit, data processing services, etc. Effective June 23, 1982, Part 309 of the FDIC's Rules and Regulations was amended to allow banks to disclose a copy of its examination report to its parent holding company or principal shareholder. Effective review of the examination report by the holding company and implementation of recommendations contained therein should assist the FDIC in the supervision of subsidiary banks. Another major benefit to an individual bank which belongs to a multi-bank holding company is that it can better serve its customers by participating loans exceeding its legal lending limit. A problem could result from this practice if the loan granted exceeds the management expertise of any of the

participants.

Holding Company Inspection Reports, prepared by the Federal Reserve Banks, are reviewed in the geographic Regional Office of the lead bank or largest subsidiary with that Regional Office providing copies of the review and Summary Analysis of Examination Reports (formerly Form 96) comments to other affected Regional Offices. The tax benefits inherent with the formation of a one-bank holding company and subsequent assumption of acquisition of debt has led to a significant increase in such entities in recent years. Many of the smaller one-bank holding companies receive infrequent inspection by the Federal Reserve. Therefore, it is important that examiners obtain current financial statements (not older than one year) on the parent company for inclusion in all examination reports. Ordinarily these holding company statements reflect little more than the bank investment and acquisition debt. It is expected that where debt servicing requirements may impact bank earnings, appropriate comments will be made by the examiner in the examination report. Reference is made to that section of the Instructions for the Preparation of Commercial Examination Report where this subject is discussed in considerably more detail.

The relationship between a bank and its parent holding company and the financial condition of the holding company could affect, to a significant degree, each of the component factors in the uniform bank rating as well as the composite ranking. To assign ratings without regard to the strength provided by sound, well-managed holding companies or to demands exerted by a weak parent would likely result in an inaccurate uniform bank rating. However, if the condition of the institution and/or its holding company becomes distressed, the actual benefits provided are less and provides little support. More or less favorable ratings should not be assigned based either on perceived financial resources of the parent holding company or on possible liabilities arising from the failing condition of an affiliated institution. The actual financial resources of the holding company can only be accurately determined if each subsidiary institution is rated according to its own true condition. Thus the ratings assigned to an individual financial institution should reflect an accurate assessment of its overall condition and soundness, including consideration of any actual holding company support. However, perceptions of parental resources and possible liabilities arising from failing affiliates should be factored into the discussion of the form of supervisory response.

III. TYING ARRANGEMENTS

The Bank Holding Company Act Amendments of 1970 and Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 added the so- called anti-tie-in provisions to the BHC Act. (Refer to the Prentice-Hall volumes.)

Essentially, the 1970 amendments provide that a bank's credit, property, or service may not be conditioned upon the customer's use of any other credit, property, or service offered by, or the customer providing any other credit, property, or service to, the bank, the bank holding company, or any of its subsidiaries. This section also precludes a bank from tying its credit, property, or service to a condition or requirement that the customer shall not obtain credit, property, or service from a competitor of the bank, the bank holding company, or any of its subsidiaries. The purpose of the provision is to prohibit anticompetitive practices which require bank customers to accept or provide some other service or product, or refrain from dealing with other parties, in order to obtain the bank product or service they desire. For example, the lending bank may not require as a necessary condition to obtaining a loan or extension of credit: that the prospective borrower lease personal property or equipment from the holding company or a subsidiary thereof of which the bank is a part; or that the prospective borrower provide the bank, its holding company or any subsidiary thereof with office supplies or equipment.

It is not intended that this provision interfere with the conduct of traditional banking practices. Thus, in dealing with banks only: loans, discounts, deposits, and trust services are excepted from the prohibition against conditioning or requiring a customer to obtain some additional credit, property, or service from the bank; and such additional credit, property, or service as is related to and usually provided in connection with a loan, discount, deposit, or trust service is likewise excepted from the prohibition against conditioning or requiring a customer to

provide some additional credit, property, or service to the bank.

The legislative history of the statute expressly states that it is not intended to affect bank correspondent relationships, but does provide that traditional correspondent relationships may not be perverted by being tied to or conditioned upon maintenance or establishment of relationships with nonbank subsidiaries of bank holding companies, or with businesses operated within the bank or by the people controlling a bank. Finally, legislative history further states that the language of the statute is not intended to prevent those traditional banking practices which protect extensions of credit by agreement to restrict other borrowings by the customer, but insures that such agreements may not be tied to or conditioned upon an agreement not to do business with competitors of other subsidiaries of the bank holding company, the bank, or the operators of the bank.

It is noteworthy that under this section, an individual may come within the meaning of a bank holding company if such individual possesses the requisite ownership or control of a bank. United States Attorneys under the direction of the Attorney General are charged with enforcing this section and private parties also have the right to sue for injunctive relief as well as treble damages when they have sustained damages, or are threatened by loss or damage, by reason of a violation of this section.

Prohibition of Preferential Loans

Title VIII amendments essentially prohibit preferential loans to executive officers, directors, and principal shareholders of a bank from its correspondent bank. Therefore, a bank which maintains a correspondent account for another bank is precluded from making an extension of credit on preferential terms to an executive officer, director, or principal shareholder of that bank, and a bank is precluded from opening a correspondent account for another bank if such ban has outstanding an extension of credit to an executive officer, director, or principal shareholder of that bank if it is on preferential terms. Conversely, a bank which maintains a correspondent account at another bank is precluded from making extension of credit on preferential terms to an executive officer, director, or principal shareholder of that bank, and a bank is precluded from opening a correspondent account at another bank if such bank has outstanding an extension of credit to an executive officer, director, or principal shareholder of that bank on preferential terms. Any bank which violates or any officer, director, employee, agent, or other person participating in the conduct of the affairs of such bank who violates this prohibition shall forfeit and pay a civil penalty.

IV. CHAIN BANKING GROUPS

From a supervisory standpoint, chain banking groups are very similar in character to multibank holding companies. They have the ability to provide many of the benefits common to multibank holding companies as well as the ability to provide the potential for unsafe and unsound banking practices. The linkage of several banks or holding companies into a chain creates a concentration of banking resources which can be susceptible to common risks. Mutually shared risks which can arise in chain banking relationships include: poor loan participation practices, common deficiencies in lending and/or investment policies, domineering or absentee ownership, insider abuses or other self-serving practices. Unfortunately, detection and correction of these problems are largely dependent on the examination process and are complicated when the chain is composed of institutions subject to different Federal and/or State regulatory agencies.

Unlike multibank holding companies chain banking organizations do not have to report financial information on a consolidated basis, thereby making offsite monitoring difficult. In addition, they are not subject to the same types of regulations as holding companies.

A chain banking organization is defined as a group (two or more) of banks or savings and loan associations and/or their holding companies which are controlled directly or indirectly by an individual or company acting alone or through or in concert with any other individual or company. Control is defined as: ownership, control or power to vote 25 percent or more of an organization's voting securities; control in any manner of the election of a majority of the directors of an organization; or the power to exercise a controlling influence over the

management or policies of an organization. However, the definition should be interpreted broadly so as to include any known or suspected chain relationship regardless of the percentage of voting control. One bank under a bank holding company or several banks owned by a single bank holding company are not considered a chain banking group for purposes of maintaining a list of chain banking groups.

It is the policy of the Division of Supervision to monitor and supervise banks that are a part of a chain banking organization in a manner which fully considers the consolidated chain's financial impact on the safety and soundness of the individual institution(s). The Regional Director is responsible for implementing and maintaining a uniform system or records designated as the "Chain Bank Report," and in establishing procedures for the periodic update and exchange of information with the other FDIC Regional Offices and other Federal and/or State regulatory authorities. Maintenance of the system includes an ongoing review of examination reports, offsite monitoring, review of change in bank control actions and information exchanged on an intragency and interagency basis. In the course of examinations, to the extent possible, financial information should be obtained from controlling individuals in order to assess any adverse impact which might redound on the chain.

In developing an overall supervisory strategy for chain organizations, the following factors should be considered:

1. The relative size and complexity of the chain's organizational structure, including the degree of centralization of operations.

2. The degree and nature of control or influence being exerted over individual institutions in the chain. Also, the managerial style and extent of direct control or influence at each institution in the chain.

3. The degree of interdependence among institutions in the chain. Particular emphasis should be given to the volume and frequency of interinstitution transactions such as: loan participations or sales; purchases or sales of securities or other assets; bank holding company or bank stock loans; insider and insider loans or transactions; and contractual obligations for services.

4. The overall condition of the institutions in the group and the condition of the chain on a consolidated basis.

V. AFFILIATES

The relationship of a bank with its affiliated organizations is important to an analysis of the condition of the bank itself. Because of the commonality of ownership or management which exists, transactions with affiliates may not be subject to the same sort of objective analysis that exists in transactions between independent parties. Also, affiliates offer an opportunity to engage in types of business endeavors which are prohibited to the bank itself yet those endeavors may affect the condition of the bank. In recognition of the importance of relationships with affiliated organizations the FDIC has been granted authority, under certain conditions, to examine affiliates in connection with its examination of a bank.

There are two primary definitions of "affiliate" which are of importance to examiners. The first is the definition set forth in Section 2(b) of the Banking Act of 1933. The second is the definition set forth in Section 23A of the Federal Reserve Act.

Affiliates as defined in Section 2(b) of the Banking Act of 1933

An "affiliate" as set forth in the Banking Act of 1933 means any corporation, business trust, association, or other similar organization (hereafter collectively referred to as "organization") which comes within one or more of the following four categories. A partnership may or may not be considered an affiliate and clarification by the Regional Office may be necessary.

Within the first category three types of affiliates are defined, each of which may be characterized as a subsidiary of a bank. That is the bank, directly or indirectly: owns or controls a majority of the voting shares of the organization; owns or controls more than 50% of the number of shares voted for the election of the organization's directors, trustees, or other persons exercising similar functions at the last election; or controls in

any manner the election of a majority of the organization's directors, trustees or other persons exercising similar functions.

The second category may be characterized as the common shareholder affiliate. This category also contains three definitions of affiliate, each of which generally is owned or controlled, directly or indirectly, by the same shareholders who own or control the bank. These include an organization which is controlled: through stock ownership or in any manner by the majority shareholders of a bank; by the shareholders of a bank who own or control more than 50% of the shares voted for the bank's directors at the last election; or by trustees for the benefit of the bank's shareholders.

The third category may be called the common directors affiliate. This definition provides that an organization is an affiliate of an insured bank if a majority of its directors, trustees, or other persons exercising similar functions are directors of a bank. It has been ruled that the common directors need not be a majority of the bank's directors, but must constitute a majority of the affiliate's directors.

The fourth category may be described as the holding or controlling affiliate. This category contains four definitions of affiliate, each of which may be characterized as being a holding company or other controlling company of a bank. Three of the definitions include affiliates which, directly or indirectly: own or control a majority of the shares of a bank; own or control more than 50% of the shares voted for the election of the bank's directors at the last election; or control in any manner the election of a majority of the bank's directors. Under the fourth definition of an affiliate in this category, all or substantially all of the capital stock of a bank is held by trustees for the benefit of its shareholders or members.

There are no substantive limitations or restrictions placed on bank relationships with affiliates based on the Banking Act of 1933 definitions; however, companies coming under this definition are affiliates, the possibility for abusive transactions does exist, and they are subject to examination by the FDIC. Affiliations arising out of the Banking Act of 1933 definitions which are not defined as affiliates under Section 23A or in other statutes or regulations should continue to be listed in examination reports and their relationships and transactions with the bank should continue to be subject to close scrutiny.

Section 23A of the Federal Reserve Act

Section 23A of the FR Act (made applicable to insured nonmember banks by Section 18(j) of the FDI Act) contains the restrictive provisions relating to transactions between banks and their affiliates. The principal purpose of Section 23A is to safeguard the resources of banks against misuse for the benefit of organizations under common control with the bank. It was designed to prevent a bank from risking too large an amount in affiliated enterprises and to assure that extensions of credit to affiliates are properly collateralized. Section 23A, therefore, regulates loans or extensions of credit to and investments in affiliates of an insured bank in two ways; first, by restricting the amount of such loans or extensions of credit and investments, and second, by requiring that the loans or extensions of credit meet certain standards as to collateral.

Section 23A of the Federal Reserve Act was completely redrafted in the Banking Affiliates Act of 1982. The Banking Affiliates Act had three major objectives. The first was to liberalize certain unduly restrictive provisions of the old Section 23A. The second was to close several potentially dangerous loopholes in the statute that would result in serious harm to banks. A third objective was to reorganize and clarify the statue to better facilitate compliance and enforcement. The Act as redrafted reflects the realities of modern day bank holding company operations.

Affiliates as Defined in Section 23A of the Federal Reserve Act

Section 23A of the Federal Reserve Act is made applicable to insured state nonmember banks by Section 18(j) of the FDI Act. Four major types of affiliates are defined in Section 23A and these are discussed in the following paragraphs.

The first category pertains to a parent holding company and its subsidiaries. Any company that controls the bank (holding company) as well as any other company that is controlled by the company controlling the bank (sister subsidiary) is considered to be an affiliate of the bank under Section 23A. "Control" is defined as owning, controlling, or having the power to vote (directly

or indirectly) 25 percent or more of any class of voting securities; or controlling in any manner the election of a majority of the directors or trustees. The term "company" means a corporation, partnership, business trust, association, or similar organization. These definitions are very similar, although not identical, to the definitions of "control" and "company" used in the Bank Holding Company Act. It is therefore possible to have a holding company-subsidiary relationship under the Bank Holding Company Act which is not an affiliate relationship for the purposes of Section 23A. Control relationships existing in certain types of trusts are an example.

Section 23A grants an important exemption with respect to domestic banks which are affiliated under this definition. When a bank is 80 percent controlled by a holding company, its transactions with other banks which are also 80 percent controlled by the same holding company are largely unrestricted. The only restrictions which do apply are the general prohibitions against a bank purchasing low-quality assets from its affiliates (refer to "Restrictions on Covered Transactions With Affiliates" below for a definition of "low quality asset"), and a requirement that all transactions be consistent with safe and sound banking practices. All restrictions and limitations set forth in Section 23A are, however, applicable to transactions by a bank with its parent holding company, its non- bank subsidiaries, and its bank subsidiaries which do not meet the 80 percent exemption. They also apply to an affiliated foreign bank even where the 80 percent test is met. The rationale for the 80 percent ownership test is that it is the minimum ownership generally required for the preparation of consolidated Federal income tax returns.

The second category consists of bank subsidiaries of a bank. A domestic bank, which is controlled by another bank, is an affiliate of the controlling institution for the purposes of Section 23A. Where such bank is, however, 80 percent controlled, it is granted the same exemption described above relative to sister bank affiliates in a holding company organization. Thus, the treatment of domestic bank affiliates is consistent whether the bank is affiliated through a holding company or by virtue of direct ownership or control.

A different situation exists with respect to non-bank and foreign bank subsidiaries. Directly owned subsidiaries of this type, whether majority or minority owned, are excluded from the definition of an affiliate for the purposes of Section 23A. This is in contrast to the treatment of such firms when they are holding company subsidiaries. (As noted above, non-bank and foreign bank subsidiaries of a holding company are affiliates and are subject to the restrictions of Section 23A). The rationale for this contrast in treatment is that non-bank subsidiaries, when majority owned by a bank, are really an integral part of the bank and transactions between the two should not normally be restricted. With respect to minority owned nonbank subsidiaries, it is noted that most banks are restricted. With respect to minority owned nonbank subsidiaries, it is noted that most banks are restricted in their ability to own stock and several of the more common types of non-bank subsidiaries (such as bank premises and safe deposit companies) are specifically exempted anyway. While this rationale serves to mitigate concern for transactions with non-bank subsidiaries in many instances, situations may arise where a bank can be exposed to undue risk. For instance, in some states banks may be able to conduct types of businesses through a non-bank subsidiary which would be prohibited to the bank itself. While the bank's investment in such a company may be limited, there may be no restriction on the amount of loans which could be made to the affiliate to fund its operations. Where evidence exists that a particular non-bank subsidiary should be brought under the restrictions of Section 23A, this can be accomplished by specific order or regulation. Any such recommendation should be forwarded to the Regional Office accompanied by supporting information.

The third category of affiliates may be referred to as companies interlocked with a banking organization. Any company which is interlocked with a bank or its holding company by virtue of common ownership or common directors is an affiliate of the bank for the purposes of Section 23A. Such interlocks will arise any time that (1) 25 percent or more of a company is owned, directly or indirectly, by or for the benefit of shareholders who have a direct or indirect ownership of 25 percent or more in either the bank or its parent holding company; or (2) a majority of a company's board of directors also comprise a majority of the board of the bank or its parent holding company.

This definition may frequently be applicable to chains of one-bank holding companies which are interlocked by ownership or board membership at the holding company level. Under this definition both the chain of holding companies and their subsidiary banks will be affiliates of a bank under examination if either of the above relevant criteria are met.

The final category is comprised of sponsored and advised affiliates. For the purposes of Section 23A, a company which is sponsored and advised on a contractual basis by a bank, or by any of the bank's subsidiaries or affiliates, is an affiliate of the bank. Real estate investment trusts are an example of this type of affiliation.

Any investment company which a bank or any of its subsidiaries or affiliates serves as an investment advisor is an affiliate of the bank. An investment advisor is basically one who, pursuant to a contract, regularly furnishes advice with respect to the desirability of investing in, purchasing or selling securities, or is empowered to determine what securities shall be purchased or sold by the investment company. The rationale for the inclusion of these two types of affiliations is that banks may, in order to protect their reputation or to forestall lawsuits alleging that bad advice was given, engage in less than arms length transactions. By according the provisions of Section 23A to such situations, a bank's potential exposure to loss can be controlled.

In addition to the four categories of affiliates defined above, Section 23A above, Section 23A also gives to the Board of Governors of the Federal Reserve System considerable latitude in defining which companies are or are not affiliated. This can be accomplished in three ways:

1. The Board of Governors may determine that "control" exists in individual situations not coming within the control definition of the Act after giving notice of and opportunity for a hearing. For example, the Board may determine that a company owning less than 25 percent of a bank's stock nonetheless exercises control over the bank and is therefore an affiliate.

2. The Board of Governors may also determine that an affiliate relationship exists in specific instances by order or regulation. For instance, the Board may determine that the relationship between an exempted subsidiary and its parent bank is such that the potential for abusive transactions exists. The Board may issue an order or regulation bringing transactions with such company under the provisions of Section 23A.

3. The Board also has the power to issue an order or regulation exempting specific types of transactions or affiliate relationships from the restrictions of Section 23A, provided that it finds that such exemption is in the public interest and consistent with the purposes of the Act.

Two final notes relating to the definition of affiliates under Section 23A concern "control" held in a trust capacity and companies acquired for debts previously contracted.

The Act specifies that no company shall be deemed to own or control another company by virtue of its ownership of shares in a fiduciary capacity with two exceptions. The first relates to affiliations arising out of the "Interlocking Companies" definition. Under this definition a company is an affiliate under a trust relationship whereby a trustee controls 25 percent or more of the voting shares of a company for the benefit of shareholders who control 25 percent or more of the voting shares of a bank or its holding company. The other exception provides that ownership or control of one company by another through a business trust creates an affiliate relationship.

With respect to the acquisition of control through debts previously contracted, the Act specifies that such companies are not affiliates for whatever period of time applicable State or Federal law or regulation permits the bank to hold such shares. In the absence of any such law the holding period is two years from date of acquisition or October 15, 1982 whichever is later. One year extensions for up to three years may be granted by the Board of Governors upon a showing of good cause. After the expiration of the allowable holding periods, such companies are deemed affiliates.

Restrictions on "Covered Transactions" With Affiliates

Section 23A(a)(1) permits a bank to engage in

covered transactions with affiliates so long as the covered transactions do not exceed, in the aggregate; (1) 10 percent of the bank's capital stock and surplus with respect to a single affiliate; and (2) 20 percent of capital and surplus with respect to all affiliates. Both the Federal Reserve Board and the FDIC have previously interpreted capital stock and surplus to include undivided profits, capital reserves, the loan valuation reserves, and valuation reserves for securities.

Covered transactions are specifically described in Section 23A(b)(7)(A) through (E) but basically consist of:

1. Loans to an affiliate;

2. Purchase of securities issued by an affiliate;

3. Purchase of nonexempted assets from an affiliate;

4. Acceptance of securities issued by an affiliated company as collateral for any loan; and

5. Issuance of a guarantee, acceptance, or letter of credit on behalf of (for the account of) an affiliate.

Reference is made to Section 23A(d)(2) through (7) for a listing of several types of transactions which are specifically exempted from the provisions of Section 23A. These transactions basically consist of deposit balances in bank affiliates, loans secured by U.S. or agency securities or deposit balances in the bank, readily marketable assets purchased at quoted market prices, loans purchased on a nonrecourse basis from affiliated banks, and the repurchase of loans previously sold to an affiliate with recourse.

The Act also contains two other important general provisions that relate to covered and exempted transactions. A bank may not purchase any "low quality asset" from an affiliate in any amount unless, pursuant to an independent credit evaluation, the bank had committed itself to purchase such asset prior to the time such asset was acquired by the affiliate. A "low quality asset" is defined as:

1. An asset which was classified as "substandard," "doubtful," or "loss" or treated as "other loans especially mentioned" in the most recent report of examination or inspection of an affiliate prepared by either a State or Federal supervisory agency;

2. An asset in a nonaccrual status because of deteriorating credit quality and/or past due status;

3. An asset on which principal or interest payments are more than 30 days past due; or

4. An asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.

This prohibition on the purchase of low quality assets also extends to bank subsidiaries. In other words, neither a bank nor any of its subsidiaries may purchase low quality assets from an affiliate. The other provision is more general but has a similar intent. This provision requires that any covered transaction between a bank and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices.

For purposes of illustration, the following loan purchase transactions provide an example of the application of Section 23A which examiners may find useful.

1. Loans Purchased from Non-Bank Subsidiaries-
   A bank may purchase any loan, including a classified loan, from its own non-bank subsidiaries since such companies are not considered affiliates under Section 23A. It matters not whether the subsidiary is minority or majority owned. The only way to control such possibly objectionable activity, other than through use of Section 8 powers, would be to have the nonbank subsidiary brought under the restrictions of 23A by order or regulation.

2. Loans Purchased from Domestic Banks which are 80 Percent Owned by Either the Bank or its Parent Holding Company - A bank may purchase loans in any amount from these affiliates provided they are not "low quality" or constitute "unsound" transactions under the provisions of Section 23A. The loans may be either subject to repurchase by the affiliate or not subject to repurchase.

3. Loans Purchased from Parent Holding Company, Sister Non-Bank Affiliates, Interlocking Non-Bank Affiliates, Sponsored Affiliates and Foreign Bank Affiliates - A bank may purchase good quality loans from these affiliates subject to the 10-20 percent capital stock and surplus limitations. Other covered transactions are aggregated for purposes of applying the amount limitations. Low-quality loans or loans whose terms and conditions are unsound may not be purchased in any amount. Loans secured by U.S. securities or repurchased loans which had been sold earlier by the bank to the affiliate on a with recourse basis are exempted, however, and would be excluded in applying the amount limitations.

4. Loans Purchased from Other Domestic Bank Affiliates - These affiliates are domestic banks controlled by either the bank or its parent holding company but which are less than 80 percent owned. This also includes banks controlled by interlocking affiliates (one-bank holding company chains, for example) whether more than or less than 80 percent owned. Loan purchase transactions with these affiliates are treated the same as loan transactions with the parent holding company, etc. (#3 above) with one exception; good quality loans may be purchased in any amount provided they are sold by the affiliated bank on a non-recourse basis.

Collateral Requirements

Loans may not be extended directly to an affiliate nor may a bank issue guarantees, acceptances, or letters of credit for the account of an affiliate unless certain collateral and margin requirements are met. Eligible collateral and margins are as follows:

1. 100 percent collateral margin if the collateral consists of U.S. Government and agency securities, deposits held in the bank which are specifically segregated and earmarked, or obligations (such as notes, drafts, or acceptances) which are eligible for rediscount or purchase by a Federal Reserve Bank;

2. A 110 percent margin is required if the collateral is composed of obligations of a state or political subdivision of a state;

3. A 120 percent margin is required if the collateral consists of other types of debt instruments, including receivables;

4. A 130 percent margin is required if the collateral is composed of stocks, leases, or other real or personal property.

It is important to note that market value at the time of the transaction is the appropriate basis for meeting margin requirements in all instances. When any collateral is subsequently retired or amortized and the amount of the remaining collateral does not provide a sufficient margin, additional eligible collateral must be supplied in an amount sufficient to meet the collateral margin required at the inception of the transaction. Where no collateral substitutions or amortizations are involved, a shrinkage in collateral value does not create a violation so long as the margin requirement was met at the inception of the transaction.

As noted above almost any type security is acceptable (provided margin requirements are met) subject to two important limitations. First, low quality assets; as that term is defined, may not be used to meet collateral requirements and, secondly, securities issued by an affiliate of a bank may not be used to secure the obligations of that affiliate or any other affiliate of the bank.

"Grandfathered Transactions"

The new provisions of Section 23A apply to any transaction entered into after October 15, 1982 (the effective date of the Banking Affiliates Act of 1982) with two exceptions:

1. The 1982 Act does not apply to transactions which were subject to a binding written contract or commitment entered into on or before July 28, 1982. Such transactions would, however, be subject to the provisions of Section 23A that existed previously to the extent that they would apply.

2. Renewals generally trigger application of the 1982 Act; however, the collateral requirements of the 1982 Act do not apply to any renewal of a participation in a loan outstanding on July 28, 1982 relative to a company that became an

affiliate as a result of the 1982 Act. Likewise, such collateral requirements do not apply to participation loans which result from renewal of a binding written contract or commitment with such an affiliate which was outstanding on July 28, 1982.

As noted in several places above, the 1982 Act gives the Board of Governors of the Federal Reserve System substantial authority to issue orders, regulations, or interpretations in its administration of Section 23A. Examiners must be familiar with any such actions taken by the Board in applying the provisions of Section 23A to state nonmember banks. Examiners will be provided information relative to any Board action having general applicability. Board actions relative to individual banks will be documented in bank files.

Section 23B of the Federal Reserve Act

Section 23B of the Federal Reserve Act applies to insured nonmember banks through section 18(j) of the FDI Act. Violations of Section 23B by nonmember banks are subject to the civil money penalties of subsection (3)(A) of Section 18(j). Section 23B, which became effective on August 10, 1987, essentially expands existing section 23A by imposing four additional types of restrictions:

1. A requirement that the terms of affiliate transactions be comparable to terms of similar non-affiliate transactions;

2. A restriction on the extent that a bank may, as a fiduciary, purchase securities and other assets from an affiliate;

3. A restriction on the purchase of securities where an affiliate is the principal underwriter; and

4. A prohibition on agreements and advertising providing or suggesting that a bank is responsible for the obligations of its affiliates.

Section 23B generally incorporates the definitions used in Section 23A, however, banks are not "affiliates" for purposes of section 23B.

The definitions and related restrictions are more fully discussed as follows:

Comparability requirement -- Transactions subject to the comparability requirement must be either:

1. On terms and under circumstances, including credit standards, that are at least as favorable to the bank or subsidiary as those prevailing at the time for comparable transactions with non-
affiliates; or

2. If there are not comparable transactions, on terms and under circumstances that in good faith would be offered to or would apply to non-affiliates.

The comparability requirement applies to the following types of transactions involving a member bank or its subsidiary:

1. Any "covered transaction," as defined in section 23A (but excluding transactions exempted under 371c(d)), with an affiliate;

2. Any safe of securities or other assets (including assets subject to an agreement to repurchase) to an affiliate;

3. Any payment of money or furnishing of services to an affiliate under a contract, lease, or otherwise;

4. Any transaction in which an affiliate acts as an agent or broker or receives a fee from the bank for its services to the bank or any other person; and

5. Any transaction with a third party if an affiliate either has a financial interest in the third party or is a participant in the transaction or a related transaction.

Moreover, for purposes of the comparability requirement, a transaction shall be deemed to be with an affiliate if any of the proceeds are transferred to or used for the benefit of the affiliate. Additionally, under the last item above, the requirement can apply to loans made to non-affiliated third parties which are dealing with an affiliate.

Restrictions on fiduciary purchases from affiliates - A bank or its subsidiary may not as a fiduciary purchase any asset or security from an affiliate unless the purchase is permitted:

1. Under the instrument creating the fiduciary relationship;

2. By court order; or

3. By the law of the jurisdiction governing the fiduciary relationship.

However, a bank will not be deemed to be a fiduciary for this purpose when acting as a broker.

Purchase of securities where an affiliate is the underwriter - A bank or its subsidiary, as fiduciary or principal, may not purchase or acquire any security, during the existence of any underwriting or selling syndication, if an affiliate is a principal underwriter of that security. However, such securities may be purchased or acquired if the acquisition is approved by a majority of a bank's directors who are not officers or employees of the bank or any of its affiliates and if the approval is granted before the securities are initially offered for safe to the public. Such approval may be either in the form of a prior approval of the specific acquisition or by the advance establishment of specific standards for such acquisitions. However, if the latter, the outside directors will be responsible for regularly reviewing acquisitions under the standards and to periodically review the standards to assure that they continue to be appropriate in light of market and other conditions.

Restrictions on responsibility for affiliate obligations - A bank, its subsidiaries, and its affiliates, may not publish any advertisement or enter into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates.

The Federal Reserve Board has the authority to issue regulations exempting transactions or relationships from the above requirements and excluding certain subsidiaries of a bank holding company from the definitions of "affiliate" for purpose of this section, if the Board finds such exemptions or exclusions to be in the public interest and consistent with the purposes of the new section 23B.

VI. SUBSIDIARIES

A bank subsidiary, as defined by Section 23A of We Federal Reserve Act, is any company of which 25 percent or more of any class of its voting stock is owned, controlled, or may be voted by We bank; or any company with respect to which a the bank controls, in any manner, the election of a majority of its directors or trustees. While several types of subsidiaries (such as bank premises companies or safe deposit companies) have long been excluded from the provisions of Section 23A, the new Act excludes any nonbank subsidiary unless specifically brought under the Section 23A umbrella by order or regulation.

The overall condition of a subsidiary can substantially affect the affairs and soundness of a bank. For example, a subsidiary in severe financial distress could precipitate a drain on the management and financial resources of the bank. Therefore, it is imperative that examinations of subsidiaries be of sufficient scope to determine compliance with law and to evaluate the bank's investment through appraisal of the subsidiary's assets, earnings, and management.

Requirements for consolidation of subsidiaries is contained in the Instructions for the Preparation of Reports of Condition and Income as mall as Instructions for the Preparation of Commercial Examination Report. Essentially all majority-owned bank premises subsidiaries and other majority-owned subsidiaries, which are considered significant according to certain tests, are consolidated. The major types of subsidiaries are:

Bank Service Corporation

A bank service corporation is defined in the Bank Service Corporation Act (the "Act") as a corporation, whose capital stock is all owned by one or more insured banks, organized to perform "authorized services." The Act limits the investment of a bank in a bank service corporation and specifies prior regulatory approval requirements. Authorized services are defined to include services such as: check and deposit sorting and posting, computation and posting of interest and other credits and charges, preparation and mailing of checks, statements, notices, and similar items, or any other clerical, bookkeeping, accounting, statistical, or similar function performed for a bank. In addition, a bank service corporation may perform any services permitted by Federal Reserve regulation for a

bank holding company under Section 4(c)(8) of the Bank Holding Company Act. These are described above in Section 11, Bank Holding Companies, under the subcaption, "Permissible Activities."

Due to the nature of services performed by these corporations, the importance of analyzing their financial condition is obvious. In addition to authority to examine affiliates (Section VI), the Bank Service Corporation Act provides that for any bank regularly examined by a Federal supervisory agency or any subsidiary or affiliate of such bank subject to examination by that agency, which causes to be performed by contract or otherwise, any bank services for itself, whether on or off premises, such performance shall be subject to regulation and examination by such agency to the same extent as if the services were being performed by the bank itself on its own premises. The bank is also required to notify the appropriate agency of the existence of such a service relationship within 30 days after the making of the service contract or the performance of the service, whichever comes first.

Safe Deposit Corporation

A safe deposit corporation primarily performs the same functions as a safe deposit department of a bank. A primary purpose for establishing such a subsidiary is to limit the bank's liability. These corporations generally are established under applicable State statutes which may contain limits on liability of the corporation for loss to a customer in any box or compartment. The safe deposit corporation should be operated under the same set of internal procedures as a normal bank safe deposit department. Additionally, the subsidiary should be protected by a combination safe depository insurance policy to the extent State law liability limitations do not provide adequate protection.

Corporation Holding Title to Bank Premises

As the name suggests, a bank premises subsidiary holds title to the bank premises and, in most cases, bases them back to the bank. Oftentimes construction/acquisition of the bank premises is financed with borrowed money and lease terms are designed to service principal and interest payments of the mortgage. The maximum investment in a bank premises subsidiary is generally limited by State law for nonmember banks. The amount of investment, direct or indirect, by a bank in bank premises can have a significant effect on overall net earnings. Therefore, it is essential when evaluating a bank's condition and earnings, that majority-owned bank premises subsidiaries be fully consolidated.

Securities Firm

A securities firm subsidiary is a subsidiary that:

1. Engages in the sale, distribution or underwriting of stocks, bonds, debentures, notes, or other securities;

2. Acts as an investment adviser to any investment company;

3. Conducts any activity for which the subsidiary is required to register with the Securities and Exchange Commission as a broker/dealer; or

4. Engages in any other securities activity.

Section 337.4 of the FDIC Rules and Regulations sets forth standards to govern the securities activities of insured State nonmember banks. Among other things, the regulation:

1. Requires such securities subsidiaries to be "bona fide" subsidiaries as defined in the regulation if they engage in securities activities or otherwise authorized to the bank under the Glass Steagall Act.

2. Requires prior notice of intent to invest in a securities subsidiary;

3. Limits the permissible securities activities; and

4. Places certain other restrictions on loans, extensions of credit, and other transactions between insured nonmember banks and their subsidiaries or affiliates that engage in securities activities.

Small Business Investment Companies (SBIC)

A SBIC is a company, organized under the Small Business Investment Act of 1958, which provides long-term credit and equity financing for small business concerns. Section 302(b) of that Act

authorizes National banks, other member banks, and nonmember insured banks (to the extent permitted by applicable State law), to invest in stock of SBICs not exceeding (in total) 5% of the capital and surplus of such banks. In no event may a bank acquire 50% or more of the shares of any class of equity securities issued by an SBIC having actual or potential voting rights. or interpretations in its administration of Section 23A. Examiners must be familiar with any such actions taken by the Board in applying the provisions of Section 23A and surplus of such banks. In no event may a bank acquire 50% or more of the shares of any class of equity securities issued by an SBIC having actual or potential voting rights.

Agricultural Credit Corporation (ACC)

These subsidiaries, established under State law, are generally a means by which a bank can obtain funding to be able to continue to service the borrowing needs of its agricultural customers. The ACC establishes a financing relationship with the Federal Intermediate Credit Bank (FICB) by buying a participation certificate in the FICB. It is then able to borrow a certain percentage of the face value of loans by discounting those loans at the FICB on a full recourse basis. The ACC is examined and regulated by the FICB and any loans classified doubtful or loss at the parent bank, which are discounted at the FICB, must be replaced.

Inasmuch as lending limits to ACC's may be separate from and in addition to the bank's limit, care should be taken to avoid a concentration of credit to any individual borrower. Wholly-owned ACCs should be examined by the FDIC with classifications reflected in a consolidated balance sheet and analysis of capital.

Special Purpose Finance Subsidiaries

A finance subsidiary is used as a mechanism for raising funds from outside investors through the issuance of collateralized debt or preferred stock. The parent bank places certain assets in the subsidiary to collateralize or otherwise support the securities issued by the subsidiary. Properly used, a finance subsidiary may enhance a bank's efforts to restructure its assets, obtain cheaper and more widely available funding sources, and improve overall profit performance.

Finance subsidiaries can also be used solely for the purpose of generating arbitrage profits rather than for the purpose of obtaining an additional source of funds. For example, a subsidiary might issue collateralized mortgage obligations and use the proceeds to simultaneously buy the mortgage-related collateral that will secure the collateralized mortgage obligation. Thus, no additional funds would be received by the parent bank since the proceeds of the securities issuance are used to purchase the underlying collateral.

Bank management has the responsibility to carefully consider the impact of finance subsidiary transactions on the bank's overall financial position. Areas requiring attention include the following:

1. Consolidation Requirements. For Reports of Income and Condition filed with the FDIC, subsidiaries that meet any one of the "significance" tests set forth in the Call Report instructions must be consolidated. Thus, securities issued to outside parties by a finance subsidiary that is wholly owned by the parent bank generally would be reported as a liability on the bank's consolidated financial statements.

2. Capital Adequacy Considerations. If required to be consolidated with the parent bank for Call Report purposes, these subsidiaries must also be consolidated for purposes of evaluating capital adequacy under the FDIC's Part 325 capital regulation. As a result, finance subsidiary transactions are normally reflected as additional assets and liabilities on the bank's consolidated Report of Condition balance sheet.

   Because the transactions generally result in an increase in total assets with no increase in capital, the potential negative impact on the capital to asset ratio effectively limits the total dollar volume of such transactions.

3. In addition, banks should carefully evaluate their overall asset/liability management, funding, and liquidity management strategies prior to entering into any proposed finance subsidiary transaction. In situations where finance subsidiary transactions are concluded

in an unsafe or unsound manner, examiners should seek appropriate supervisory remedies.

Corporations Engaged in International Banking Activities

Edge Act Corporation - A Federally-chartered corporation organized under Section 25(a) of the Federal Reserve Act and subject to Federal Reserve Regulation K. Edge Act Corporations are allowed to engage only in international banking or other financial transactions related to international business. They are chartered and regulated by the Federal Reserve System and must have a minimum capital of $2,000,000 and a minimum life of 20 years. Their purpose is to aid in financing and stimulating foreign trade. An Edge Act subsidiary is a bank's majority-owned Edge Act Corporation and is treated for purposes of Reports of Income and Condition as a "foreign office."

Agreement Corporation - A State-chartered corporation that has agreed to operate as if it were organized under Section 25 of the Federal Reserve Act and has agreed to be subject to Federal Reserve Regulation K (refer to the Prentice-Hall volumes). Banks must apply to the Federal Reserve for permission to acquire stock in an Agreement Corporation which is restricted principally to international banking operations.

Mortgage Banking Subsidiaries

Mortgage banking subsidiaries engage in the origination and/or purchase of mortgages for sale in the secondary market and the servicing of mortgages. The major functions of a mortgage banking subsidiary are:

1. Origination, which includes application processing, underwriting, and closing;

2. Secondary marketing, which includes purchases and sales, warehousing, packaging and shipping, investor relationships, and risk management; and

3. Servicing, which includes mortgage accounting, escrow administration, collections, customer service, and investor reporting.

Insurance Subsidiaries

There is considerable variety in the laws and regulations of the states. Some allow bank subsidiaries to engage in insurance agency or brokerage operations, while others do not. Some limit the products that may be offered. Types of insurance products include credit liability, casuality, automobile, life, health, accident, title insurance, and private mortgage insurance. Insurance activities are generally regulated by the insurance departments of the various states.

Real Estate Subsidiaries

State laws vary with respect to permissible real estate activities which may be conducted through bank subsidiaries. A number of states permit real estate brokerage activities. Others permit equity participations, which involve passive investment roles, and some states permit bank subsidiaries to engage in real estate development and ownership in an active role. In many cases investments are limited in terms of percentages of an institution's total assets or capital.

VII. EXAMINATION AUTHORITY

As previously indicated, authority of examiners to examine affiliates of State nonmember banks is contained in Sections 10(b) and 10(c) of the FDI Act. However, examinations of affiliates that are considered advisable or necessary by the examiner must be supported by definite reasons and it is essential that no examination be undertaken without prior clearance from the Regional Office. In exercising the authority to examine State nonmember insured banks and their affiliates, examiners are empowered by Section 10(b) to make a thorough examination of all of the affairs of the bank and its affiliates and are directed to make a full and detailed report of condition of the bank to the FDIC. The authority to examine affiliates extends to both those defined under Section 2(b) of the Banking Act of 1933 as well as those set forth in Section 23A of the Federal Reserve Act. Although some indications of an affiliate relationship may be present, in some cases it may be difficult, if not impossible, to ascertain through customary examination techniques whether or not such a relationship exists. In such cases and where all other means have failed, Section 10(c) can be a useful tool in obtaining the information and data necessary to

enable the Examiner to make a factual determination as to the existence of any such relationship as well as the nature and extent of any transactions between the bank under examination and the other entity.

Use of Section 10(c) powers is not limited to situations involving affiliate relationships. Among other things, Section 10(c) empowers the FDIC to issue, in the course of an examination, subpoenas and to take and preserve testimony under oath so long as the documentation or information sought relates to the affairs or ownership of the bank being examined. Accordingly, individuals, corporations, partnerships, or other entities which in any way affect the bank's affairs or ownership may be subpoenaed and required to produce documents under the FDIC's Section 10(c) powers.

While proper use of Section 10(c) powers can be a valuable aid to the FDIC in carrying out its supervisory responsibilities, misuse of such powers can be a source of harm and embarrassment not only to the FDIC but also to the bank and the third parties involved. Accordingly, the exercise of Section 10(c) powers should not be undertaken without prior consultation with the Regional Director and authorization from the Director, Division of Supervision.

Examination authority covering bank service corporations is set out in Section 7 of the Bank Service Corporation Act.

VIII. EXAMINATION OF SUBSIDIARIES

Nonbank subsidiaries which engage in activities which are not authorized directly for the insured depository institution should be subject to close scrutiny to determine that such activities do not endanger the parent institution's safety and soundness. Unlike affiliates, whose activities may be shielded from the insured institution through the holding company structure and the provisions of Sections 23A and 23B of the Federal Reserve Act, the liabilities of a subsidiary may flow directly to the insured institution if appropriate barriers between the insured institution and its subsidiaries are not in place. Even with barriers, the legal precedents are such that there is no guaranty that the liabilities of a subsidiary may not adversely impact the parent. Thus, in order to determine the true condition of the parent organization, an evaluation of the subsidiary's activities, particularly those subsidiaries engaged in activities not authorized directly for an insured institution, must be performed. The scope of the evaluation should be sufficient to assess the value of the bank's investment and whether the subsidiary is in overall compliance with law. The depth of subsidiary examinations will vary according to the degree of perceived risk. If a high risk profile is evident, more extensive examination procedures may be required. The objective is for examiners to reach a level of comfort sufficient to assess the overall condition of the subsidiary and its impact on the parent. Prior clearance from the Regional Office is not required to examine subsidiaries of insured institutions. An examination of some types of subsidiaries may require specialized expertise.

While examination procedures generally call for the consolidation of subsidiaries in preparation of Reports of Examination, examiners should be alert to situations where an unconsolidated analysis may appropriately reflect a limit on a bank's exposure to the amount of its investment in the subsidiary and not to the total liabilities of the subsidiary.

Depending on the type of subsidiary, a more in-depth evaluation will generally involve assessment of the following areas:

Asset Quality

The examiner should sample the quality of assets, review delinquency reports where appropriate, and evaluate the written operating policies to determine the extent of any loss. Evaluation standards should be similar to those used for bank assets.

Funding and Liquidity

A determination should be made of the types of funding necessary for the subsidiary's activities, the reliability of present funding, and the extent to which the subsidiary's activities are being funded by the bank. An excessive reliance on any one source of funding may indicate future liquidity problems or undue reliance on the parent to provide funding.

Adequacy of Capital

To the extent possible, a determination of the adequacy of the subsidiary's capital should be made after reviewing asset quality, sources of funding, earnings, and management. Capital levels should be compared to regulatory requirements or other standards considered appropriate for the type of business the subsidiary is engaged in. This capital cushion is an important insulation to protect the bank from liabilities of the subsidiary.

In reviewing the parent bank's capital adequacy, the bank's investment in its subsidiary should be deducted from both assets and capital. This analysis will indicate the effect on the parent should the subsidiary become insolvent.

Earnings

The earnings stream of the subsidiary should be reviewed to determine if there is reliance on onetime gains or if there is a failure to recognize losses on a timely basis. Fees received from the bank, salary structure and overhead expenses should be reviewed to ensure that charges are in line with those which would be made to third parties.

Management

Daily management of the subsidiary should be structured so as not to create the presumption that the activities of the subsidiaries are in any way conducted by the bank. Advertising and any required disclosures should be reviewed to ensure that the public is not given the perception that subsidiary activities are guaranteed by the bank or insured by the FDIC.

Firewalls

The term "firewalls" is used to describe a concept of separation of responsibility for entities providing different services but which are commonly owned. Firewalls generally include separate corporate formalities, management, employees, accounting, and policies. Also, the operations of the subsidiary should be physically distinct from the operations of the insured institution. FDIC Rules and Regulations Section 337.4 is an example of a firewall construction designed to insulate the bank from liability of the subsidiary; compliance with Section 337.4 should be reviewed where applicable.